LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
SEP 19 1963
JOHN F. DAVIS, CLERK

IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1963**

No. 482

ROBERT S. GERSTELL AND ALICE R. GERSTELL,
*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

RICHARD H. APPERT,
*Counsel for Petitioners,*
14 Wall Street,
New York 5, New York.

*Of Counsel:*
DAVID SACHS.

## TABLE OF CONTENTS


| | PAGE |
|---|---|
| OPINIONS BELOW | 1 |
| JURISDICTION | 2 |
| QUESTIONS PRESENTED | 2 |
| STATUTES INVOLVED | 2 |
| STATEMENT OF THE CASE | 4 |
| REASONS FOR GRANTING THE WRIT | |
| 1. The decision of the United States Court of Appeals for the Third Circuit in the present case conflicts with decisions of the United States Courts of Appeals for the Second and Ninth Circuits | 11 |
| 2. The present case involves two important questions with respect to the federal income tax laws which have not been, but should be, settled by this Court: | |
| a. Deduction of net out-of-pocket expenditures as expenses or losses | 14 |
| b. Retroactive reversal of Treasury Department policy | 21 |
| 3. The issues involved in the present case are common to numerous other cases of a similar nature | 27 |
| CONCLUSION | 28 |
| APPENDIX | |
| A. Opinion below | 29 |

## CITATIONS

### Cases


| | PAGE |
|---|---|
| *Arnfeld v. United States*, 143 Ct. Cl. 277, 163 F. Supp. 865 (1958), *cert. denied*, 359 U. S. 943 (1959) | 17 |
| *Automobile Club v. Commissioner*, 353 U. S. 180 (1957) | 23 |
| *Becker v. Commissioner*, 277 F. 2d 146 (2d Cir. 1960) | 12, 13, 17, 27 |
| *Bond v. United States*, 52 P-H A.F.T.R. 1262, 57-1 C.C.H. U.S.T.C. ¶9680 (S.D. Tex. 1957), *aff'd*, 258 F. 2d 577 (5th Cir. 1958) | 16 |
| *DeWoskin, Morris R.*, 35 T.C. 356 (1960) | 12 |
| *Dogle v. Commissioner*, 286 F. 2d 654 (7th Cir. 1961) | 18 |
| *Fox v. Commissioner*, 190 F. 2d 101 (2d Cir. 1951) | 18 |
| *Goodstein v. Commissioner*, 267 F. 2d 127 (1st Cir. 1959) | 27 |
| *Hood, Clifford F.*, 20 C.C.H. T.C.M. 1140 (1961) | 24 |
| *Knetsch v. United States*, 364 U. S. 361 (1960) | 16, 20, 21 |
| *Loughran, John*, 19 C.C.H. T.C.M. 1193 (1960) | 24 |
| *Lynch v. Commissioner*, 273 F. 2d 867 (2d Cir. 1959) | 27 |
| *MacRae v. Commissioner*, 294 F. 2d 56 (9th Cir. 1961), *cert. denied*, 368 U. S. 955 (1962) | 12, 13, 17, 27 |
| *Phillips, Percy W.*, 30 T.C. 866 (1958), *rev'd*, 275 F. 2d 33 (4th Cir. 1960) | 17 |
| *Putnam v. Commissioner*, 352 U. S. 82 (1956) | 19 |
| *Stanton, L. Lee*, 34 T.C. 1 (1960) | 24 |
| *Weller v. Commissioner*, 270 F. 2d 294 (3d Cir. 1959), *cert. denied*, 364 U. S. 908 (1960) | 21, 25 |

## Statutes


| | PAGE |
|---|---|
| Internal Revenue Code of 1939: | |
| Section 23(e)(2) | 13, 17 |
| Section 23(g)(1) | 13 |
| Section 117(g)(2) | 12, 13 |
| Section 3791(b) | 23 |
| Internal Revenue Code of 1954: | |
| Section 165 | 13, 17 |
| Section 264(a) | 23 |
| Section 1211 | 13 |
| Section 1212 | 13 |
| Section 1234(a) | 12, 13 |
| Section 7805(b) | 23, 24 |


## Regulations


| | |
|---|---|
| Treasury Regulations: | |
| Section 601.201(l)(5) | 25 |
| Section 601.201(l)(9) | 23 |


## Ruling


| | |
|---|---|
| Rev. Rul. 54-94, 1954-1 Cum. Bull. 53 | 22 |


## Committee Report


| | |
|---|---|
| Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, Progress Report, April 22, 1957 | 23, 25 |


## Other


| | |
|---|---|
| 2 CCH 1963 Stand. Fed. Tax Rep. | 27 |
| 2 P-H 1963 Fed. Taxes | 27 |

IN THE

# Supreme Court of the United States

## OCTOBER TERM, 1963

No.

ROBERT S. GERSTELL and ALICE R. GERSTELL,
*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit, entered on June 26, 1963.

### Opinions Below

The opinion of the Tax Court of the United States is Tax Court Memorandum Decision 1962-181. The Tax Court opinion is reported at 21 C.C.H. T.C.M. 994, 1962 P-H T.C.M. ¶62, 181 (1962), and is printed in the Appendix for the use of the Court below at pages 82a-92a. The opinion of the United States Court of Appeals for the Third Circuit is reported at 63-2 C.C.H. U.S.T.C. ¶9565.

12 P-H A.F.T.R. 2d 5017 (1963) and is printed in Appendix A, *infra*, p. 29.

## Jurisdiction

The judgment of the Court of Appeals was rendered on June 26, 1963 and was entered by the Clerk on the same day. The jurisdiction of this Court is based on 28 U. S. C. 1254(1).

## Questions Presented

1. Is an individual taxpayer who entered into a transaction in order to realize an after-tax profit entitled to deduct out-of-pocket expenditures incurred in such transaction as expenses for the production of income or as losses from a transaction entered into for profit?

2. May the respondent retroactively reverse his administrative position, widely publicized through official rulings, as to the taxpayer who relied on such position to his detriment, particularly when the respondent continued to give effect to such position with respect to similar transactions in the cases of other taxpayers?

## Statutes Involved

The statutes involved in this proceeding are the following:

**Internal Revenue Code of 1939:**

> Section 23(a)(2)—"In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> "Non-trade or non-business expenses.—In the case of an individual, all the ordinary and necessary

expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

Section 23(e)(2)—"In computing net income there shall be allowed as deductions:

* * * * *

"Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * *

"if incurred in any transaction entered into for profit, though not connected with the trade or business * * *"

Section 117(g)(2)—"[G]ains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short-term capital gains or losses * * *"

Section 3791(b)—"Retroactivity of Regulations or Rulings.—The Secretary or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect."

**Internal Revenue Code of 1954:**

Section 165—"Losses.

"(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

"(c) Limitation on Losses of Individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * * * *

discussed, several courts of appeals have rejected this restrictive view of profit taken by the Tax Court.

In *Doyle* v. *Commissioner*, 286 F. 2d 654 (7th Cir. 1961), the Commissioner made the same argument as in the present case that the taxpayer should not be allowed a loss upon a sale of stock because the loss had been incurred, in circumvention of the wash-sale provisions, in order to reduce taxes. The court rejected this argument, stating:

> "As for the profit element as part of the criterion of 'economic substance', it is sufficient that the sale was made to establish a capital loss. It is an everyday occurrence for a taxpayer to time the sale of capital assets to match up capital losses and gains. Such sales are entered into for 'profit' to the degree that they ultimately minimize tax liability, thereby increasing the net business income of the taxpayer." 286 F. 2d at 659.

The court thus recognized that the concept of profit includes the minimization of tax liabilities. In this respect *Doyle* went even further than the present case since *Doyle* involved a transaction entered into solely to obtain a capital loss deduction. The present case, on the other hand, involved not only an expected interest deduction but also an expected capital gain which, taken together, would result in an after-tax profit.

The tax concept of a transaction entered into for profit was discussed in some detail by the Second Circuit in a case involving the deductibility of a loss incurred by making a guaranty of indebtedness in the hope of reducing or minimizing other losses. *Fox* v. *Commissioner*, 190 F. 2d 101 (2d Cir. 1951). The court held the loss

deductible[3] and make the following answer to the Commissioner's contention that avoidance of a loss is not encompassed within the profit motive for tax purposes:

> "Respondent argues, however, that this guaranty cannot have been a contract entered into with any idea of profit, that rather it was at best only the hope of avoiding loss. He says: 'But for all the record shows, a profit was impossible under this arrangement, just as it was impossible under the loan arrangement six months earlier. Furthermore, as an undertaking to protect the securities already loaned, it is difficult to believe that an ordinary prudent business man would have executed such a guaranty under the circumstances of this case unless impelled by some motive entirely disassociated from a profit motive. There is nothing in the record to even remotely suggest that the giving of this guaranty could prevent the loss of securities already loaned without causing the guarantor to sustain a corresponding or even greater loss as a direct result of the execution of the guaranty.' We think this a misconstruction of the law on transactions 'entered into for profit.' As we said in Feine *v.* McGowan, 2 Cir., 188 F. 2d 738, 740: 'The Supreme Court has said that deductibility of losses under this section depends upon "whether the taxpayer's motive in entering into the transaction was primarily profit." Helvering *v.* National Grocery Co., 304 U. S. 282, 289, n. 5, 58 S. Ct. 932, 936, 82 L. Ed. 1346.' In this connotation it would seem clear

---

3. This Court, in *Putnam* v. *Commissioner*, 352 U. S. 82, 93 n. 21 (1956), indicated disapproval of the ultimate holding in *Fox* that loss by an individual on a guaranty of indebtedness is deductible as an ordinary nonbusiness loss. However, this Court did not disapprove of the Second Circuit's views with respect to the profit motive, but rather based its opinion on the ground that loss arising from a guaranty falls within a specific limitation in the Internal Revenue Code providing that losses from nonbusiness bad debts are deductible only as capital losses.

> that the hope of monetary gain—as distinguished from some other consideration, such as family relationship or donative intent—is what is controlling and no sound distinction can be drawn as between cutting losses and showing a positive gain. From the low point her securities had reached at the time of the 1932 transaction, every step would seem upward, and hence within the meaning of 'pecuniary gain' necessary to the profit motive. Goldsborough *v.* Burnet, 4 Cir., 46 F. 2d 432, 433; Feine *v.* McGowan, supra." 190 F. 2d at 104.

Thus, the court recognized that avoidance of a loss is an economic gain.

Similarly, in the present case, the attempt to obtain an after-tax profit is, for purposes of the expense or loss provisions of the Internal Revenue Code, an adequate profit motive. Although the petitioner's expectations have not been met, it is as unrealistic to say that he did not enter into the transaction for profit, as it would be to say that a person buying stock did not have a profit motive if he in fact incurred a loss on the stock. The petitioner has paid out $148,009.08 in what was unmistakably "the hope of monetary gain." The respondent, using epithets such as "sham" and "lack of economic substance," seeks to strike down the deduction of this amount by reliance upon the momentum created by the *Knetsch* case. But the issues of the deductibility of the interest and of the deductibility of the out-of-pocket expenditures are entirely different. It is one thing to disallow an interest deduction in excess of the net amount actually paid out by a taxpayer; it is quite another to disallow an expense or loss deduction equal to the actual out-of-pocket expenditure.

The Third Circuit's decision in the present case in effect has equated capital gains with tax-exempt income

by denying deductions attributable thereto. Under the Third Circuit's view it is not enough to seek a capital gain in order to qualify for a deduction, but the capital gain sought must exceed the expenditures incurred in order for the latter to be deductible. Whether such a limitation may be engrafted upon the statutory provisions allowing the deduction of expenses and losses is a question which should be decided by this Court, since it places in doubt the proposition reaffirmed even in the *Knetsch* case that a tax avoidance motive is irrelevant so long as the transaction in question is not a sham. While there may have been inadequate substance to the interest deduction, there is most certainly substance to the $148,009.08 spent by the petitioner from his own funds and never recovered by him in any manner.

### b. *Retroactive reversal of Treasury Department policy.*

On the ground that the issue had not been raised by the petitioner in *Knetsch* v. *United States*, *supra*, this Court expressly declined to decide the issue raised in an amicus brief whether the Commissioner was bound by his position expressed in certain letter rulings which held that the interest was deductible. 364 U. S. at 370. Shortly thereafter, this Court denied certiorari in a case which had considered the issue and had held that the Commissioner was not required to allow interest deductions to a taxpayer who had not himself received a letter ruling. *Weller* v. *Commissioner*, 270 F. 2d 294 (3d Cir. 1959), *cert. denied*, 364 U. S. 908 (1960).

The present case again presents this issue, but in a substantially different context. The question in the present case is not whether the Commissioner can retroactively

reverse his position allowing the interest deduction, but whether fundamental principles of fairness and due process do not dictate that the Commissioner must allow the deductions of at least the out-of-pocket expenditures incurred by the petitioner in reliance upon the position consistently maintained by the Commissioner for more than five years.

The record in the present case includes copies of seven letter rulings issued by the respondent to various taxpayers in the years 1947, 1948, 1950, 1951, and 1952. The latest of these rulings was dated November 6, 1952, less than seven weeks before the petitioner entered into the transactions involved in the present case. These rulings, which involved transactions substantially identical to those of the petitioner, consistently held that interest payments exactly like those made by the petitioner were deductible for income tax purposes. It was not until March 1954 when Rev. Rul. 54-94, 1954-1 Cum. Bull. 53, was published that the respondent gave any indication that he would no longer allow such deductions. The petitioner submits that, under these circumstances, his reliance on the position of the respondent is an additional and independent ground for the allowance of the deduction of his out-of-pocket expenditures, at least to the extent they were incurred before the publication of Rev. Rul. 54-94.

At the outset, it should be made perfectly clear that the petitioner does not contend that one taxpayer may rely on a letter ruling issued to another taxpayer. This is not a situation in which the petitioner saw and relied on one or two letter rulings; rather, the petitioner relied on a well-established administrative interpretation of the law which was evidenced by a consistent series of letter rulings spanning a period of over five years. These rulings were widely publicized (though not published) by

insurance companies and their agents. See Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, Progress Report, April 22, 1957, pp. 191-192. Under the particular circumstances of this case, the petitioner contends that it is an abuse of the Commissioner's discretion under section 7805(b) of the Internal Revenue Code of 1954 to revoke retroactively this administrative interpretation and to disallow not only the interest deductions, but also the deduction of out-of-pocket expenditures which the petitioner incurred in reliance thereon.

It has been recognized by all three branches of the government that in certain instances retroactive application of a new law or interpretation is improper. For example, in amending the Internal Revenue Code in 1954 expressly to deny a deduction for interest paid on indebtedness incurred in purchasing a single premium annuity contract, Congress provided that the new law "shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954." Int. Rev. Code of 1954, § 264(a). Furthermore, the respondent himself has established a general policy, at least when a ruling is published, to make a revocation or modification prospective only. Treas. Reg. § 601.201(l)(9). This Court has indicated in *Automobile Club* v. *Commissioner*, 353 U. S. 180 (1957), that it could be improper for the Commissioner to revoke a letter ruling retroactively. In that case, this Court approved the revocation of a ruling issued to an automobile club with limited retroactive effect: the letter ruling had been revoked only with respect to the years following the issuance of a published ruling taking a contrary position. This limited retroactive action by the Commissioner was held by this Court not to have been an abuse of his discretion under section 3791(b) of the Internal Revenue

Code of 1939 (now, section 7805(b) of the 1954 Code). This Court made it clear, however, that the Commissioner's action was approved only because his retroactive action in that particular case did not have inequitable results and indicated that retroactive action which did have inequitable results would be reversed.

In the present case the inequity is twofold. First, the respondent is denying all deductions for tax years prior to his published change in position in 1954; second, he is doing so only as to those taxpayers who did not obtain their own letter rulings.

The application of the 1954 ruling to pre-1954 tax years is particularly unfair in a case such as the present one. As previously noted, the first court decision contrary to the letter rulings was not decided until 1959. At the time he acted, the petitioner was reassured by a five-year series of consistently favorable rulings which were the only authoritative pronouncements in the area. Were it not for this obvious expression of the respondent's position on this matter, the petitioner never would have borrowed from the insurance company to finance the annuity contracts. He could have used his readily available line of bank credit to carry the contracts, in which case he may well have been allowed to deduct the interest payments. *John Logathran*, 19 C.C.H. T.C.M. 1193 (1960); *L. Lee Stanton*, 34 T.C. 1 (1960); *Clifford F. Hood*, 20 C.C.H. T.C.M. 1140 (1961). Thus, the respondent has required the petitioner to pay tax deficiencies and substantial amounts of interest arising from transactions which the petitioner never would have consummated except for the fact that the respondent had placed his stamp of approval upon the transactions.

The respondent insists that he may revoke the unpublished rulings without regard to the effect upon taxpayers

other than the ones to whom they have been issued. This may be so in some, or perhaps most, situations. However, the petitioner maintains that in this case the respondent is abusing his discretion in attempting to revoke retroactively not only a particular ruling but an administrative position spanning a period of more than five years. Under these circumstances, the respondent's unpublished rulings were at least as effective in inducing reliance thereon as a published ruling would have been.

The basic unfairness of the retroactive change of position in the present case is compounded by the fact that those taxpayers who have obtained rulings are protected against retroactive change, at least to the extent of the detriment suffered in reliance upon the rulings. See Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, Progress Report, April 22, 1957, pp. 191-192, in which it is indicated that taxpayers with rulings are allowed to deduct net out-of-pocket expenditures. Such treatment of persons with rulings is in accordance with the general procedure set forth in the regulations on the revocation of letter rulings, Treas. Reg. 601.201(l)(5). This means that a select group will be allowed a deduction while other taxpayers such as the petitioner will be denied a deduction for amounts paid at the very time the Commissioner was issuing rulings approving such deductions.

The Third Circuit, in *Weller* v. *Commissioner*, *supra*, approved such a result on the ground that there was no abuse of discretion because all taxpayers without rulings were being treated equally by the Commissioner. However, it is not enough that all persons who did not receive rulings are being treated equally. The discrimination against the petitioner based merely on his failure to obtain a ruling with his name typed on it when such rulings were

available for the asking is clearly improper. It violates the principle that all men are equal before the law. Are we to assume that a ruling would have been denied to the taxpayer even though such rulings were being granted to others? Obviously not! Then no sensible policy (administrative or otherwise) is served by a rule which would say that no matter how many taxpayers have received rulings on an issue and despite the fact that such rulings are widely publicized, no person may rely on the position taken in such rulings unless he submits a request for an identical ruling with his name on it. From the point of view of the respondent, it would seem that such a rule would be undesirable since the result would be needlessly to clog the ruling channels of the Internal Revenue Service with *pro forma* requests for more and more rulings on points on which the Commissioner's position is clear and well known.

It is submitted that the injuries to the petitioner in this case at the hands of the federal government deserve consideration by this Court and redress in spite of the fact that they are only financial in nature. There comes a point at which principles of equity must override the general rules protecting the government against the errors and vagaries of its employees and agents; that point has been passed in this case. Perhaps the Commissioner should be entitled to correct his errors—even retroactively; but we urge that this Court should not permit such errors to be corrected at the expense of a taxpayer who in good faith relied upon the erroneous position which was subsequently corrected. The disallowance of the out-of-pocket expenditures incurred by the petitioner prior to the correction of the error would be an affirmative penalty not provided for by the tax law and not merited by the petitioner.

### 3. The issues involved in the present case are common to numerous other cases of a similar nature.

The numerous letter rulings issued by the Commissioner with respect to transactions similar to the present one and the extensive promotion of such transactions by insurance agents throughout the country have resulted in a great number of persons entering into such transactions without obtaining a ruling. A glance at the tax services indicates that more than 20 cases similar to the present one have been reported. 2 CCH 1963 Stand. Fed. Tax Rep. ¶¶16,275G-2757; 2 PH 1963 Fed. Taxes ¶13,006. There is no way of determining how many additional cases are pending in the lower courts, or are at the stage of administrative negotiation between the taxpayer and the Internal Revenue Service, or have not even reached that stage.

In most of these cases it is inevitable that one or both of the present issues will be raised. In many of the decided cases, those issues involving the deductibility of out-of-pocket expenditures have not already been raised because of the holdings in *Becker* and *MacRae* that such expenditures are not deductible until the taxable year in which the transaction is closed out. See also, *Goodstein* v. *Commissioner*, 267 F. 2d 127 (1st Cir. 1959); *Lunch* v. *Commissioner*, 273 F. 2d 867 (2d Cir. 1960). Both the government and many taxpayers will be compelled to expend much effort and money if the present issues are not settled by this Court. If this Court does not grant certiorari now, the possibility that it may eventually do so will lead to much needless litigation. Consequently, it would be to the benefit of both the United States and

the many taxpayers who have similar cases that this Court hear and decide the present case.

## CONCLUSION

**For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.**

Respectfully submitted,

RICHARD H. APPERT,
*Counsel for Petitioners.*

DAVID SACHS,
*Of Counsel.*

## APPENDIX A

## Opinion Below

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 14291

ROBERT S. GERSTELL AND ALICE R. GERSTELL,
*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

APPEAL FROM THE TAX COURT OF THE UNITED STATES

Argued June 4, 1963

Before BIGGS, *Chief Judge*, and MCLAUGHLIN and KALODNER, *Circuit Judges*

## OPINION OF THE COURT

(Filed June 26, 1963)

PER CURIAM.

We can perceive no error in the proceedings of the Tax Court in this case though the review is vigorously pressed by the petitioners. Consequently the decision of the Tax Court will be affirmed on the comprehensive opinion of Judge Black.

A True Copy:

Teste:

*Clerk of the United States Court of Appeals for the Third Circuit.*